OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT: SRLY SUBGROUP ISSUES

This Field Service Advice responds to your memorandum dated July 2, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

X =

Pre-Merger X Subs = [1]

[1]The new name of post-merger X is Z. For simplicity, we will refer to Z as X, Z's name prior to the name change.

Y =

Pre-Merger Y Subs =

Z =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Date A

$b =

ISSUE #1:

With respect to net operating loss carryovers of X and the Pre-Merger X Subs, whether X, the new common parent of the Y group following the reverse acquisition, is a member of a SRLY subgroup composed of members of the terminating X group for Year 4 and Year 5.

CONCLUSION #1:

From the facts provided to us, we believe the taxpayer has not complied with Treas. Reg. § 1.1502-21T(g)(3); as a result, the taxpayer is not eligible to use SRLY subgroup rules for Year 4 and Year 5. However, assuming arguendo the taxpayer is entitled to use SRLY subgroup rules for Year 4 and Year 5, we believe X (the new

common parent of the Y group following the reverse acquisition) is a member of a SRLY subgroup composed of members of the terminating X group, with respect to net operating loss carryovers of X and the Pre-Merger X Subs.

ISSUE #2:

Whether the portion of the pre-acquisition NOLs of the former X group, attributable to X, are subject to the separate return limitation year ("SRLY") limitations.

CONCLUSION #2:

The portion of the pre-acquisition NOLs of the former X group, attributable to X, are subject to the separate return limitation year ("SRLY") limitations.

FACTS:

During Year 1, X and its subsidiaries filed for protection under Chapter 11 of the United States Bankruptcy Code. During Year 2, the Boards of Directors of X and Y agreed to the merger of X and Y as part of the plan of reorganization ("Plan") of X's debtors. Under the Plan, Y would be merged with and into X with X becoming the surviving corporation. Thereafter, X would be renamed.[2] While X would operate the existing businesses of X and Y, the directors and officers of Y immediately before the merger would become the directors and officers of X. The Plan projected that X's affiliated group would have at least $b amount of NOLs as of the date of the merger.

The Bankruptcy Court approved both the merger agreement and the Plan. The merger ultimately took place on Date A. As a result of owning shares of Y, the shareholders of Y, immediately after the acquisition, owned more than 50% of the fair market value of the outstanding stock in X.

Consequently, the X group terminated; X became the common parent of the Y group; and the Pre-Merger X Subs also became members of the Y group. Short period returns were filed by the X group for the period ended Date A. Each of the Y group's consolidated returns for Year 3, Year 4, and Year 5 reflected X as part of the Y subgroup that included the Pre-Merger Y Subs, rather than part of X subgroup that included the Pre-Merger X Subs. However, the Y group's consolidated return

[2]As already indicated, the new name of post-merger X is Z. For simplicity, we will refer to Z as X, Z's name prior to the name change.

for Year 6 reflected X as part of the X subgroup, rather than as part of the Y subgroup.

DISCUSSION

LAW AND ANALYSIS

Law

Treas. Reg. § 1.1502-1(e) provides that the term "separate return year" means a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group.

Treas. Reg. § 1.1502-1(f)(1) provides that, except as otherwise provided, the term "separate return limitation year" means any separate return year of a member or of a predecessor of such member.

As a general rule, net operating losses reported on a separate return can be carried over and used on a consolidated return under the rules of section 172. Treas. Reg. §1.1502-21A(b)(1) (and former Treas. Reg. § 1.1502-21(b)(1)) limits a consolidated group's ability to use net operating losses sustained by any members of the group in "separate return limitation years." Treas. Reg. §1.1502-21A(c) (and former Treas. Reg. § 1.1502-21(c)) provides that the net operating loss of a member of an affiliated group arising in a "separate return limitation year" that may be included in the consolidated net operating loss deduction of the group shall not exceed the amount of the consolidated taxable income contributed by the loss member for the taxable year at issue.

Treas. Reg. § 1.1502-21T(c)(2) provides SRLY subgroup rules that are generally effective for consolidated return years beginning on or after January 1, 1997. Under these subgroup rules, the SRLY limitation is applied on a subgroup basis, rather than a member-by-member basis.

Treas. Reg. § 1.1502-21T(g)(3) generally provides that a consolidated group may apply the subgroup rules of this section to all consolidated return years ending on or after January 29, 1991, and beginning before January 1, 1997, provided that –

> (i) The group's tax liability as shown on an original or an amended return is consistent with the application of the rules of this section (other than this paragraph (g)) and §§ 1.1502-15T, 1.1502-22T, 1.1502-23T, 1.1502-91T through 1.1502-96T, and 1.1502-98T for each such year for which the statute of limitations does not preclude the filing of an amended return on January 1, 1997;

(ii) Each section described in paragraph (g)(3)(i) of this section and § 1.1502-1(f)(4)(ii) is applied by substituting "taxable years ending on or after January 29, 1991" for "taxable years beginning on or after January 1, 1997" (and "before January 29, 1991" for "before January 1, 1997" in the case of consolidated return changes of ownership) as the context requires;

(iii) The rules of paragraph (c) of this section and §§ 1.1502-15T and 1.1502-22T(c) are applied only with respect to the losses and deductions of those corporations that became members of the group (including members of a subgroup), and to acquisitions occurring, on or after January 29, 1991, (and only with respect to such losses and deductions);

(iv) The rules of §§ 1.1502-15A, 1.1502-21A(c) and 1.1502-22A(c) are applied with respect to the losses and deductions of those corporations that became members of the group, and to acquisitions occurring, before January 29, 1991; and

(v) Appropriate adjustments are made in the earliest subsequent open year to reflect any inconsistency in a year for which the statute of limitations precludes the filing of an amended return on January 1, 1997.

Discussion Issue 1

The tax years in the instant case are Year 4 and Year 5, which are tax years beginning before January 1, 1997. To be eligible to use SRLY subgroup rules for these years, the taxpayer needed to have complied with each of the specific requirements under Treas. Reg. § 1.1502-21T(g)(3). From the facts provided to us, we believe the taxpayer has not complied with each of these Treas. Reg. § 1.1502-21T(g)(3) requirements. Consequently, the taxpayer is not eligible to use SRLY subgroup rules in Year 4 and Year 5.

The facts indicate the taxpayer failed, in at least the following respect, to consistently apply the rules under Treas. Reg. § 1.1502-21T to all applicable years.[3] The taxpayer treated X as part of the Y subgroup for Year 3, Year 4, and Year 5, but treated X as part of the X SRLY subgroup for Year 6. (You confirmed to us that this inconsistency, for each of these years, involved pre-acquisition losses of X and the Pre-merger X Subs that became loss carryovers in the Y group.) Although you believe the taxpayer intends to file amended returns to consistently apply the rules

[3] [redacted]

under Treas. Reg. § 1.1502-21T to all applicable years, Treas. Reg. § 1.1502-21T(g)(3) also requires the taxpayer to consistently apply the rules of Treas. Reg. § § 1.1502-15T, 1.1502-22T, 1.1502-23T, 1.1502-91T through 1.1502-96T, and 1.1502-98T for each year for which the statute of limitations does not preclude the filing of an amended return on January 1, 1997.

In applying the section 382 rules to consolidated groups under Treas. Reg.1.1502-91T through 1.1502-96T, and 1.1502-98T, Treas. Reg. § 1.1502-99T(d)(4) provides that a taxpayer must have made the amended returns under that section of the regulations by March 25, 1997. Thus, the taxpayer cannot now file any necessary amended returns under that section. Consequently, if the taxpayer needs to file amended returns under that section, the group has failed to comply with the requirements under Treas. Reg. § 1.1502-21T(g)(3) in not consistently applying Treas. Reg. § 1.1502-21T and Treas. Reg. § 1.1502-91T through 1.1502-96T and 1.1502-98T.[4]

Discussion Issue 2

Treas. Reg. § 1.1502-1(f)(3) provides that the portion of the pre-acquisition NOLs of the former X group attributable to X are subject to the separate return limitation year ("SRLY") limitations.

Treas. Reg. § 1.1502-1(f)(3) provides that:

> In the event of an acquisition to which Sec. 1.1502-75(d)(3) applies, all taxable years of the first corporation and of each of its subsidiaries ending on or before the date of the acquisition shall be treated as separate return limitation years, and the separate return years (if any) of the second corporation and each of its subsidiaries shall not be treated as separate return limitation years (unless they were so treated immediately before the acquisition). For example, if corporation P merges into corporation T, and the persons who were stockholders of P immediately before the merger, as a result of owning the stock of P, own more than 50 percent of the fair market value of the outstanding stock of T, then a loss incurred before the merger by T (even though it is the common parent), or by a subsidiary of T, is treated as having been incurred in a separate return limitation year. Conversely, a loss incurred before the merger by P, or by a subsidiary of P in a separate return year during all of which such subsidiary was a member of the group of which P was the common parent

[4] [redacted]

> and for which section 1562 was not effective, is treated as having been incurred in a year which is not a separate return limitation year. (emphasis added).

However, in determining the SRLY limitation (not using the subgroup rules) under Treas. Reg. § 1.1502-21(c)(2), the amount of income against which the pre-acquisition NOLs, attributable to X, are applied is as follows: the consolidated taxable income of the group, (computed without regard to the consolidated net operating loss deduction), minus such consolidated taxable income recomputed by excluding the items of income and deduction of post-merger X (i.e., Z). Reg. § 1.1502-1(f) provides, in part, that the term "separate return year" means any separate return year of a member or of a predecessor of such member. The term "predecessor' means a transferor or distributor of assets to a member in a transaction to which section 381(a) applies. The reorganization transaction is a transaction to which section 381(a) applies. Under the reverse acquisition rules, X is treated as a transferor corporation for purposes of section 381. See Treas. Reg. § 1.1502-75(d)(3)(v)(b). Accordingly, under section 381(a), post-merger X (i.e., Z) succeeds to and takes into account X's loss carryovers, and the separate return limitation year rule of Treas. Reg. § 1.1502-21(c)(2) is computed with respect to post-merger X (i.e., Z). Cf. Rev. Rul. 75-378, 1975-2 C.B. 355.[5]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[5] [redacted]

[redacted]

If you have any further questions, please call 622-7930.

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By: _____
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